

**MORTGAGE AND LAND BANK  
OF LATVIA**

**Condensed Consolidated and Bank Financial Statements  
for the year ended 31 December 2010  
(unaudited)**

*Mortgage and Land Bank of Latvia*  
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***Report of the Supervisory Council and the Board of Directors***

On 3 December 2009, the concept for “Transformation of the State-owned JSC “Mortgage and Land Bank of Latvia” into Development Bank” was approved by decree No 820 issued by the Cabinet of Ministers of the Republic of Latvia. The concept stipulates that Mortgage Bank be transformed into a development bank through phasing out the transactions characteristic to a commercial bank and focusing the activities of the Bank onto the branches crucial for the national economy.

Year 2010 highlights a significant step for the state-owned JSC “Mortgage and Land Bank of Latvia” on its way to development bank. The purpose of transformation is to establish a development bank for implementation of the state aid programmes by making maximum use of the infrastructure of the Mortgage Bank, its intellectual and financial potential, effecting the transformation to the best for the state and maintaining implementation continuity of the state aid programmes.

In September 2010, in accordance with the decision of the Cabinet of Ministers, a consultant – “SEB Enskilda” was attracted to the transformation. The draft transformation plan of the Mortgage Bank prepared by the financial consultant is being examined by interdepartmental working group on management of the transformation process of the Mortgage Bank headed by Mārtiņš Bičevskis – state secretary of the Ministry of Finance. The Cabinet of Ministers is to pass a decision on approval of the transformation plan.

In the complex economic situation of Latvia the Mortgage Bank proceeded with lending to the local companies operating in the branches identified by state as crucial for the national economy thus replenishing the service range of the commercial banks. In 2010 the proportion of state aid target programmes in the overall loans’ portfolio of the Mortgage Bank has reached 41%. Despite the fact that in 2010 the Mortgage Bank didn’t grant new commercial loans and consumer loans outside the promotional programmes, the number of retail customers remained unchanged. Whereas, the number of corporate customers increased due to implementation of the state aid programmes which testified to high customer confidence in the bank.

Also in 2011 the Mortgage Bank will continue to increase the volumes of state aid programmes by lending to entrepreneurs and promoting development of the national economy of Latvia. At the same time the Bank will proceed with improvement of quality of the services of the bank and maintaining high level of customer service.

**Financial Sector and its Trends**

On 31 December 2010, banking services in the Republic of Latvia were provided by 21 bank and 8 subsidiaries of foreign banks. The state-owned JSC “Mortgage and Land Bank of Latvia” operates as the only 100% state-owned commercial bank.

In 2010 the most significant event in the banking sector of Latvia was restructuring of JSC “Parex banka”. A new commercial bank (JSC “Citadele banka”) was established whereto the good assets were transferred leaving the rest of the assets with the so called resolution bank that continues working under the name of Parex banka.

During 11 months of 2010, the assets of the banks have decreased by 1%, reaching 21.5 bln lats at the end of November, but capital and reserves of the banks have grown by 2%. In the aforementioned period the unaudited losses of the banks amounted to 327 mln lats which was two times less than recorded in the same period last year. The major cause of losses was provisioning for risky assets. At the end of November, the profit of the banking sector before provisions and taxes amounted to 136 mln lats.

Due to prudent credit policy pursued by banks and low demand on the part of customers, the loan portfolio shrunk by 6% during 11 months of 2010. Although banks continued granting new loans, the lending volume of the banking sector in general was still less than the amounts repaid by customers and written off by banks as lost.

Meanwhile the volume of deposits grew by 10.5%, due not merely to stabilisation of the economy, but also changes to the bookkeeping of the banks – as of May, the deposits attracted as subordinated obligations are included in the deposits.

In 2010 the commercial banks concentrated on quality of the loan portfolio. Although the loan portfolio of the banking sector without late payments shrunk gradually in the first half-year, it stabilised in the second half reaching 72% at the end of November. In the 11 months of 2010, the provisions for doubtful loans rose from 8.6% to 11.4% of the total loan portfolio of the banks.

The Bank of Latvia requirements to statutory reserves have not changed since 2008: for liabilities of banks over 2 years – 3%, for all other liabilities included in the reserve base – 5%.

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**Report of the Supervisory Council and the Board of Directors (continued)**

In 2010, the US Federal Reserve System didn't change the base interest rate of dollar, the European Central Bank also maintained the euro base interest rate unchanged at 1.0%. Nevertheless, the Bank of Latvia decreased the base interest rate for lat from 4% to 3.5%. The decisions of the central banks and fluctuations of the money market have affected the average interest rates of loans granted by commercial banks of Latvia. The average interest rates for loans (in lats) granted to individuals decreased from 18.9% (in January 2010) to 16.5% (in December 2010), and for legal entities – from 10.1% to 5.2% in the respective period. Also, the average interest rates for loans granted in foreign currencies have diminished: for legal entities – from 5.0% to 4.7%, and for individuals – from 5.4% to 5.1%.

**Operational Results**

In 2010 the gross assets of the Mortgage Bank decreased by 158.4 mln lats or 16%, stopping at 808.2 mln lats (market share – 3.7%) due to repayment of syndicated and other interbank long-term borrowings in the amount of 174.3 mln lats.

The loan portfolio (gross) has shrunk by 16% reaching 594.2 mln lats (market share – 4.2%) consisting of the development loan portfolio – 244.5 mln lats (41% of the loan portfolio) and commercial loan portfolio – 349.7 mln lats (59% of the loan portfolio). In the reporting period, the volume of deposits has grown by 36.9 mln lats reaching 363.6 mln lats (market share – 4.1%). In 2010, the Bank accumulated provisions for risky assets in the amount of 81.6 mln lats, as a result of that, the losses were 67.9 mln lats. As at 31 December 2010, the ratio of the Bank's provisions and loan portfolio was 15.6%.

As at the end of December, the capital adequacy ratio was 16.7% that significantly exceeded the statutory minimum of 8% required by the Credit Institution Law. In April 2010, the equity capital of the Bank was increased by 70.28 mln lats. The equity capital was increased as a result of the state taking over the obligations of the Mortgage Bank towards the Nordic Investment Bank and investing the said amount in the equity capital of the Bank. The European Commission (EC) has been notified of the increase of the equity capital. The EC will pass its decision on the issue after analysis of the transformation plan of the Bank.

The beginning of 2010 was marked with a positive assessment of the economic development potential of Latvia, acknowledged also by international rating agencies *Standard & Poor's Rating Services* and *Moody's Investors Service Ltd* through upgrading the credit rating outlook of Latvia to stable from negative. The Mortgage Bank is 100% state-owned bank and its rating is directly linked to the sovereign rating of Latvia. Having upgraded the rating outlook on the Latvian government's local and foreign currency rating of Baa3 to stable from negative, the *Moody's Investors Service Ltd* also changed the outlook on Mortgage Bank's Baa3 long-term foreign currency deposits rating to stable from negative. The Bank is assigned the following ratings:

- long-term foreign currency deposits – *Baa3*,
- short-term foreign currency deposits – *P3*,
- financial strength rating – *E+*,
- rating of mortgage bonds – *Baa2*,

which are investment grade ratings.

At the end of 2010 the Mortgage Bank serviced its customers in 25 branches and 9 sub-branches located in Riga and other cities of Latvia. In 2010, the Mortgage Bank optimised its customer service network, as a result of which one sub-branch was closed in Riga and two branches transformed into sub-branches. The optimisation of the service network outside Riga will continue in 2011.

**Implementation of State Aid Programmes**

In 2010, the Mortgage Bank proceeded with implementation of the effective state aid programmes and phasing out its commercial loan portfolio. As regards commercial activities, the Bank has ceased lending to new customers. The Bank granted commercial loans only to the existing customers in proportion to the already granted loans and for restructuring of the loans of the current commercial customers of the Bank.

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*Report of the Supervisory Council and the Board of Directors (continued)*

In 2010, the Mortgage Bank, as commissioned by government, continued to implement the following state aid programmes providing support to specific groups of entrepreneurs and population:

- Programme for Improvement of Competitiveness of Businesses;
- Micro-lending Programme;
- Start-up programme “Support to Self-employment and Business Start-ups”;
- SME Growth Programme “Loans for Promotion of Development of Micro, Small and Medium Enterprises and Agricultural Co-operative Unions”;
- Working Capital Loans for Farmers.

*Programme for Improvement of Competitiveness of Businesses*

To finance the programme the Mortgage Bank borrowed from the Nordic Investment Bank (NIB) 100 mln euros (70 mln lats) in 2009. The programme is also financed by Loan Fund consisting of public financing in the amount of 61.6 mln euros (43.3 mln lats) and Mortgage Bank’s financing in the amount of 21.6 mln euros (15.2 mln lats). By the end of 2010 the Programme for Improvement of Competitiveness of Businesses had granted loans for 146.7 mln lats, including 58.5 mln lats from the Loan Fund.

*Micro-lending Programme*

The total financing volume of the programme – 564.8 thsd lats is fully consumed. The Bank keeps granting micro loans from the resources repaid by borrowers. By the end of 2010 the Mortgage Bank had granted 296 micro loans for the sum total of 806 thsd lats.

*Start-up programme „Support to Self-employment and Business Start-ups”*

By the end of 2010, 1267 applicants had applied for consultations and training, 610 participants of the programme had completed their training, 498 business plans were submitted to the Bank of which 455 were examined by credit committee and 267 projects were financially supported for the total loan amount of 3.8 mln lats.

*SME Growth Programme*

In February 2010 the Bank launched the SME Growth Programme „Loans for Promotion of Development of Micro, Small and Medium Enterprises and Agricultural Co-operative Unions”. The aim of the programme is to enhance access to funding for entrepreneurs registered in Latvia to revive and stimulate the development of the national economy of Latvia. On the 2<sup>nd</sup> of October 2009, to implement the programme, the Mortgage Bank concluded a 100 mln euro loan agreement with the European Investment Bank. In February 2010 the Mortgage Bank received the first tranche of the loan in the amount of 50 mln euro. By the end of September the SME Growth Programme had granted loans for 8.9 mln lats.

*Working Capital Loans for Farmers*

In May 2010 the Mortgage Bank started to grant working capital loans to farmers. The loans are granted in line with the Cabinet of Ministers Regulation No 403 of 27 April 2010 “Procedure for Granting State Aid for Acquisition of Working Capital for Production of Agricultural Produce”. The total financing volume of the programme is 10 mln lats that the Mortgage Bank will receive from the State Treasury in the form of loans. As at the end of September the programme had granted 200 loans for the total amount of 7.5 mln lats.

*Credit Fund*

On 20 July 2010, the Cabinet of Ministers Regulation No 664 “Procedure of administration and monitoring the state and European Union support to agriculture, rural territories and development of fish farming, by establishing a Credit Fund” (hereinafter – Credit Fund) got approved, which provides for granting loans to finance projects approved by the Rural Support Service. Loans are to be granted to investments into agricultural enterprises – construction, procurement of stationary machinery and its equipment, procurement of building material and development of detail design. Loans are granted with maturity up to 15 years, with fixed or variable rate in LVL and EUR currencies. By the end of 2010, the Mortgage Bank had approved 3 projects for the total amount of 1.4 million lats.

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*Report of the Supervisory Council and the Board of Directors (continued)*

During 2011 we will proceed with realisation of Banks transformation according to the decisions made by the government in order to achieve goals of the conception approved on 3 December 2009, which stipulates that transformation shall be finalised by 31 December 2013. Taking into consideration that after 31 December 2013 the Bank will be left with certain amount of commercial activities, during 2011. Analyses will be made to assess the most effective solution for servicing commercial activities after transformation phase.

During 2011 the Bank will also continue with internal restructuring and will strengthen its capacity to realise state support programs in the name of the government. To continue previous year traditions, the Bank plan to closely cooperate with established Regional fund in different regions of Latvia to realise socially responsible projects and promote activities and self-initiative of local residents to improve their surrounding environment.

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**Supervisory Council (at 31 December 2010)**

Baiba Bāne	Chairman of the Council
Andžs Ūbelis	Deputy Chairman of the Council
Jānis Pone	Member of the Council

During the reporting period Ms. Baiba Brigmane and Mr. Dāvids Tauriņš resigned from the Council and Mr. Jānis Pone and Andžs Ūbelis were appointed as members of the Council.

**Board of Directors (at 31 December 2010)**

Rolands Paņķo	Chairman of the Board
Jēkabs Krieviņš	Deputy Chairman of the Board
Jānis Bērziņš	Member of the Board
Baiba Brigmane	Member of the Board
Gints Āboltiņš	Member of the Board

During the reporting period Andris Riekstiņš resigned from the Board and Baiba Brigmane and Gints Āboltiņš as were appointed as members of the Board.

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*Statement of Responsibility of the Supervisory Council and the Board of Directors*

The Supervisory Council and the Board of Directors (Management) are responsible for preparing the financial statements from the books of prime entry of the Group and the Bank for each financial period that present fairly the state of affairs of the Group and the Bank as at the end of the financial period and the results of their operations and cash flows for that period according to the International Financial Reporting Standards as adopted by the European Union. Prudent and reasonable judgments and estimates have been made by the Management in the preparation of the financial statements.

Management confirms that suitable accounting policies have been used and applied consistently and reasonable and prudent judgments and estimates have been made in the preparation of the condensed consolidated and bank financial statements for the period ended 31 December 2010. Management also confirms that applicable International Financial Reporting Standards as adopted in EU have been used in preparation of the financial statements and that these financial statements have been prepared on a going concern basis. Appropriate accounting policies have been applied on a consistent basis.

Management is responsible for keeping proper accounting records, for taking reasonable steps to safeguard the assets of the Group and the Bank and to prevent and detect fraud and other irregularities. Management is also responsible for managing the Bank in compliance with the Law on Credit Institutions, regulations of the Bank of Latvia and the Financial and Capital Market Commission as well as other legislation of the Republic of Latvia.

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STATEMENT OF FINANCIAL POSITION (all amounts in thousands of Lats)

	Notes	2010		2009	
		Group	Bank	Group	Bank
Interest income		46,900	46,413	58,348	55,815
Interest expense		(27,953)	(27,964)	(30,960)	(30,551)
<b>Net interest income</b>		<b>18,947</b>	<b>18,449</b>	<b>27,388</b>	<b>25,264</b>
Fee and commission income		3,912	3,250	3,892	3,557
Fee and commission expense		(980)	(1,013)	(996)	(1,025)
<b>Net fee and commission income</b>		<b>2,932</b>	<b>2,237</b>	<b>2,896</b>	<b>2,532</b>
Dividend income		-	-	5	52
Net trading income		1,594	1,739	6,166	6,319
Other operating income		4,410	2,054	2,075	1,110
		<b>27,883</b>	<b>24,479</b>	<b>38,530</b>	<b>35,277</b>
Personnel expenses		(8,866)	(7,788)	(9,625)	(8,573)
Administrative expenses		(6,873)	(5,997)	(8,112)	(7,194)
Depreciation and amortisation		(1,912)	(1,727)	(2,036)	(1,834)
Impairment expenses		(76,407)	(76,887)	(74,101)	(72,733)
<b>Loss before income tax</b>		<b>(66,175)</b>	<b>(67,920)</b>	<b>(55,344)</b>	<b>(55,057)</b>
Income tax expense		(33)	-	934	1,006
<b>Net loss for the period</b>		<b>(66,208)</b>	<b>(67,920)</b>	<b>(54,410)</b>	<b>(54,051)</b>
Net gain from investment securities available-for-sale		3,067	3,067	528	528
<b>Total comprehensive loss for the period</b>		<b>(63,141)</b>	<b>(64,853)</b>	<b>(53,882)</b>	<b>(53,523)</b>
<b>Net (loss) / profit for the period attributable to:</b>					
Equity holders of the Bank		(66,316)	-	(54,421)	-
Non-controlling interest		108	-	11	-
<b>Total comprehensive (loss) / profit for the period attributable to:</b>					
Equity holders of the Bank		(63,249)	-	(53,893)	-
Non-controlling interest		108	-	11	-
<b>Earnings per share</b>					
Equity shareholders of the parent for the year:					
Basic and diluted earnings per share (expressed in LVL per share)		(0.38)		(0.67)	

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STATEMENT OF FINANCIAL POSITION (all amounts in thousands of Lats)

<u>Assets</u>	Notes	31/12/10		31/12/09	
		Group	Bank	Group	Bank
Cash and balances with Central Bank		68,177	68,177	95,997	95,997
Due from credit institutions		20,774	16,692	35,411	35,276
Derivative financial instruments		862	862	1,954	1,954
Trading securities		2,572	2,374	5,074	4,919
Investment securities – available for sale		71,504	77,765	49,892	49,892
Investment securities – held to maturity		24,614	24,614	42,984	42,984
Loans to customers		491,741	470,534	632,681	639,501
Deferred expenses and accrued income		1,182	2,049	662	532
Investment properties		10,574	1,159	1,166	1,166
Property and equipment		6,583	6,074	7,536	6,896
Intangible assets		1,811	1,447	2,204	1,721
Investments in subsidiaries and associated undertakings		-	818	280	1,528
Other assets		5,659	2,298	8,896	1,865
Assets held for sale		-	30,945	-	-
<b>Total assets</b>		<b>706,053</b>	<b>705,808</b>	<b>884,737</b>	<b>884,231</b>
<b><u>Liabilities</u></b>					
Due to credit institutions		167,771	167,771	379,512	379,512
Derivative financial instruments		13	13	155	155
Due to customers		361,163	363,622	326,699	326,761
Issued debt securities		32,589	33,046	37,429	38,249
Deferred income and accrued expenses		1,686	1,224	3,997	3,376
Provisions for off-balance sheet commitments		1,054	1,054	189	189
Current income tax liabilities		40	-	43	-
Deferred tax liabilities		10	-	27	-
Other liabilities		24,903	24,308	27,211	26,646
Subordinated liabilities		31,089	31,089	31,089	31,089
<b>Total liabilities</b>		<b>620,318</b>	<b>622,127</b>	<b>806,351</b>	<b>805,977</b>
<b><u>Shareholder's equity</u></b>					
Share capital		191,601	191,601	121,321	121,321
Reserve capital		2,524	2,063	2,524	2,063
Revaluation reserve on available for sale investments		33	33	(3,034)	(3,034)
Accumulated loss		(108,781)	(110,016)	(42,465)	(42,096)
<b>Total shareholder's equity attributable to shareholders of the Bank</b>		<b>85,377</b>	<b>83,681</b>	<b>78,346</b>	<b>78,254</b>
Non-controlling interest		358	-	40	-
<b>Total shareholder's equity</b>		<b>85,735</b>	<b>83,681</b>	<b>78,386</b>	<b>78,254</b>
<b>Total liabilities and shareholder's equity</b>		<b>706,053</b>	<b>705,808</b>	<b>884,737</b>	<b>884,231</b>

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**CONSOLIDATED STATEMENT OF CHANGES IN THE GROUP'S EQUITY**

(all amounts in thousands of Lats)

	Attributable to equity holders				Minority interest	Total equity
	Share Capital	Reserve capital	Revaluation deficit on available for sale investments	Retained earnings		
<b>Balance as at 31 December 2008</b>	<b>48,513</b>	<b>2,524</b>	<b>(3,562)</b>	<b>12,922</b>	<b>29</b>	<b>60,426</b>
Loss for the period	-	-	-	(54,421)	11	(54,410)
Other comprehensive expenses	-	-	528	-	-	528
<b>Total comprehensive (loss) / profit for the period</b>	<b>-</b>	<b>-</b>	<b>528</b>	<b>(54,421)</b>	<b>11</b>	<b>(53,882)</b>
Shareholders cash contribution	72,808	-	-	-	-	72,808
Distribution of profit – payment for use of state capital	-	-	-	(966)	-	(966)
<b>Balance as at 31 December 2009</b>	<b>121,321</b>	<b>2,524</b>	<b>(3,034)</b>	<b>(42,465)</b>	<b>40</b>	<b>78,386</b>
Loss for the period	-	-	-	(66,316)	108	(66,208)
Other comprehensive income	-	-	3,067	-	-	3,067
<b>Total comprehensive (loss) / profit for the period</b>	<b>-</b>	<b>-</b>	<b>3,067</b>	<b>(66,316)</b>	<b>108</b>	<b>(63,141)</b>
Increase in minority interest (IPS „Hipo Fondi”)	-	-	-	-	210	210
Shareholders cash contribution	70,280	-	-	-	-	70,280
<b>Balance as at 31 December 2010</b>	<b>191,601</b>	<b>2,524</b>	<b>33</b>	<b>(108,781)</b>	<b>358</b>	<b>85,735</b>

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**STATEMENT OF CHANGES IN THE BANK'S EQUITY**  
(all amounts in thousands of Lats)

	Share Capital	Reserve capital	Revaluation deficit on available for sale investments	Retained earnings	Total equity
<b>Balance as at 31 December 2008</b>	<b>48,513</b>	<b>2,063</b>	<b>(3,562)</b>	<b>12,921</b>	<b>59,935</b>
Loss for the period	-	-	-	(54,051)	<b>(54,051)</b>
Other comprehensive expenses	-	-	528	-	<b>528</b>
<b>Total comprehensive (loss) / profit for the period</b>	<b>-</b>	<b>-</b>	<b>528</b>	<b>(54,051)</b>	<b>(53,523)</b>
Shareholders cash contribution	72,808	-	-	-	<b>72,808</b>
Distribution of profit – payment for use of state capital	-	-	-	(966)	(966)
<b>Balance as at 31 December 2009</b>	<b>121,321</b>	<b>2,063</b>	<b>(3,034)</b>	<b>(42,096)</b>	<b>78,254</b>
Loss for the period	-	-	-	(67,920)	<b>(67,920)</b>
Other comprehensive income	-	-	3,067	-	<b>3,067</b>
<b>Total comprehensive (loss) / profit for the period</b>	<b>-</b>	<b>-</b>	<b>3,067</b>	<b>(67,920)</b>	<b>(64,853)</b>
Shareholders cash contribution	70,280	-	-	-	<b>70,280</b>
<b>Balance as at 31 December 2010</b>	<b>191,601</b>	<b>2,063</b>	<b>33</b>	<b>(110,016)</b>	<b>83,681</b>

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**STATEMENT OF CASH FLOWS** (all amounts in thousands of Lats)

	2010		2009	
	Group	Bank	Group	Bank
<b>Cash flows from operating activities</b>				
(Loss) before taxation	(66,175)	(67,920)	(55,344)	(55,057)
Depreciation and amortisation	1,912	1,727	2,036	1,834
Increase in provision for impairment losses	76,407	76,887	74,101	72,733
(Profit) / loss from sale of property and equipment	(191)	9	(420)	81
Increase/ (decrease) in deferred income and accrued expenses	(2,330)	(2,152)	1,387	1,494
(Increase)/ decrease in deferred expenses and accrued income	(520)	(1,517)	56	32
(Increase) / decrease in other assets	(4,748)	1,233	(5,722)	(2,261)
Increase in other liabilities	(1,585)	(1,615)	13,926	14,065
<b>(Decrease)/ increase in cash and cash equivalents from operating activities before changes in assets and liabilities</b>	<b>2,770</b>	<b>6,652</b>	<b>30,020</b>	<b>32,921</b>
Decrease in balances due from credit institutions	3,177	3,177	32,853	32,853
Decrease in loans to customers	64,373	61,084	37,806	15,678
Decrease/ (increase) in trading securities	2,502	2,545	(1,232)	(1,208)
(Decrease) / increase in balances due to credit institutions	20,624	20,624	(109,997)	(90,696)
Increase in balances due to customers	34,464	36,861	22,325	22,276
Decrease in debt securities issued	(4,840)	(5,203)	(3,231)	(2,411)
<b>Cash and cash equivalents used in operating activities</b>	<b>123,070</b>	<b>125,740</b>	<b>8,544</b>	<b>9,413</b>
<b>Corporate income tax paid</b>	<b>(33)</b>	<b>-</b>	<b>(2)</b>	<b>-</b>
<b>Cash flows from investing activities</b>				
Purchase of investment securities	(173,404)	(179,665)	(226,248)	(226,248)
Sale of investment securities	173,456	173,456	225,341	225,341
Purchases of property and equipment	(807)	(654)	(1,106)	(974)
Proceeds from property and equipment disposal	346	14	891	22
Proceeds from disposal of investments in associated entities	-	-	16	-
Acquisition of investments in associated entities	-	-	-	-
<b>Cash and cash equivalents used in investing activities</b>	<b>(409)</b>	<b>(6,849)</b>	<b>(1,106)</b>	<b>(1,859)</b>
<b>Cash flows from financing activities</b>				
Increase in minority interest	210	-	-	-
Repayment of syndicated loan	(145,480)	(145,480)	-	-
Shareholders cash contribution	-	-	43,290	43,290
Dividend paid	-	-	(966)	(966)
<b>Cash and cash equivalents generated from financing activities</b>	<b>(145,270)</b>	<b>(145,480)</b>	<b>42,324</b>	<b>42,324</b>
<b>Increase / (decrease) in cash and cash equivalents</b>	<b>(22,642)</b>	<b>(26,589)</b>	<b>49,760</b>	<b>49,878</b>
Cash and cash equivalents at the beginning of the year	111,062	110,927	61,302	61,049
<b>Cash and cash equivalents at the end of the year</b>	<b>88,420</b>	<b>84,338</b>	<b>111,062</b>	<b>110,927</b>
Cash flow from interest received	44,350	44,136	54,902	52,963
Cash flow from interest paid	27,633	27,644	34,078	33,343

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## **1 GENERAL INFORMATION**

The Mortgage and Land Bank of Latvia was established as a state-owned commercial bank on 19 March 1993 by the Government of Latvia based on the Decree No 140 adopted by the Cabinet of Ministers. The Bank was registered with the Register of Enterprises of the Republic of Latvia on 3 June 1993. According to the Commercial Law the Bank was registered in the Commercial Register on 14 July 2004.

The operations of the Bank are regulated by the law On Credit Institutions and other effective laws of the Republic of Latvia, the Statutes of the Bank, the instructions of the Bank of Latvia and Financial and Capital Market Commission, as well as the decrees and regulations of the Cabinet of Ministers of the Republic of Latvia. The Bank is under the jurisdiction of the Ministry of Finance of the Republic of Latvia that represents the interests of the shareholder on behalf of the Cabinet of Ministers and holds 100% of the Bank's shares.

The principal activities of the Bank have been divided by commercial activities, where Bank provides universal bank's services, and state support programs, where Bank issues loans under state and European Union programs.

On 3 December 2009, the concept for Transformation of the State-owned JSC Mortgage and Land Bank of Latvia into a Development Bank was approved by Order No 820 issued by the Cabinet of the Republic of Latvia. The concept stipulates that the Mortgage Bank be gradually transformed into a development bank, phasing out commercial functions to completely refuse from them by 31 December 2013 at the latest. The Mortgage Bank will be gradually reducing its commercial loan portfolio and the portfolio balance outstanding at the end of the transition period will be realised or transferred to another financial institution.

In April 2010 the shareholder of the Bank increased share capital of the Bank by LVL 70 million. The Shareholder sent a notification to European Commission requesting to approve the share capital increase. The management of the Bank expects that decision will be made after review of Bank's transformation plan as described below. Thus, the approval from European Commission towards the bank's shareholder is still pending at the date of the issue of these Financial Statements. If this approval was not been obtained, the bank's shareholder would need to perform actions to obtain repayment of made capital increase. The increase has been recognized as equity and included in capital adequacy calculation.

In September 2010, in accordance with the Cabinet's decision, a consultant – SEB Enskilda - was attracted to ensure the transformation process. The consultant was engaged to draw the transformation plan of the Bank. The transformation plan shall include actions to be taken by the Bank, which currently have not been agreed and therefore are uncertain.

Therefore, the Bank's management has not been able to assess the potential effect, if any, which the approval of the transformation plan, including related approval on Bank's equity, could produce on the Bank's future operations, presentation of Bank's asset and liability term structure and their valuations, as well as capital adequacy. A decision on the transformation plan will be adopted by the Cabinet of the Republic of Latvia after the approval of the annual report.

Given the existing circumstances, the Bank's management has adopted the going concern assumption based on the budget and action plan for 2011 approved by the Bank's Council and shareholder, stating that the Bank will be in compliance with all regulatory requirements and assuming positive decision over capital increase made in April 2010. The Bank's management also expects that the transformation plan that will be approved to implement the transformation process will encompass measures and resources which may be necessary to achieve compliance with the regulatory requirements and will not cast any doubt upon the appropriateness of the going concern assumption.

These financial statements on pages 9 to 77 have been accepted by the Board of Directors on 3 February 2011 and accepted by the Supervisory Council on 9 February 2011. In accordance with the Commercial Law of the Republic of Latvia, the shareholders' meeting has the right to make decision on approval of the financial statements.

## **2 RISK MANAGEMENT**

The Group and the Bank manages all the major risks affecting the operation of the Group and the Bank in accordance with the Risk Management Policy approved by the Council of the Bank. The Risk Management Policy stipulates and describes the aggregate of measures used to ensure that a possibility of suffering losses is minimized in the event the invested or receivable resources would not be repaid or recovered in due time or full amount or the Group or the Bank would suffer other losses or would not derive the planned profit. Risk management is an integral component of the internal control system of the Group and the Bank and the risk management system has been established taking into account the size and structure of the Group and the Bank, as well as the best advisable practice, incl. the guidelines of Basel bank supervisory committee.

The Group and the Bank abides by the following principles in its risk management:

- risk assessment and management shall be an integral component of the every-day functions of the Group and the Bank;
- while assuming the risks the Group and the Bank shall be capable of implementing the aims and assignments defined in its development strategy in a longer run;
- the Group and the Bank shall operate by maintaining an optimum balance between profitability and safeguarding against the risks, i.e. the profitability must be as high as possible, however, the Group and the Bank shall not be exposed to material risks;
- in accordance with their authority and competence the employees of the Group and the Bank shall know the customer and understand fully the nature of each transaction (operation) to be able to identify and assess the risks associated with the transaction (operation) and find the best solution both for the customer and the Group or the Bank;
- the Group and the Bank shall assess the probable losses that it might incur by assuming the risks and avoid extraordinary losses in its operation;
- the Group and the Bank shall identify and assess the probable risks before launching new products or services or entering new markets;
- where necessary, the Group and the Bank shall reduce the risk limits, sell the assets subject to the risk or even cease operations on the respective markets should these be assessed as excessively risky.

In light of the changes in the world's financial markets and economy, the Group and the Bank continued improving the risk management system, developing and improving risk management methods, which enhance more accurate and timelier identification of the major risks characteristic to operations of the Group and the Bank and evaluate their impact on further operation of the Group and the Bank.

In managing the risks the Group and the Bank apply various methods and instruments for measuring risks, set the limits and maintain the appropriate controls. The Council of the Bank has approved the policies for managing the risks characteristic for operations of the Group and the Bank.

Each of the structural units involved in risk management maintains an appropriate internal control, efficiency assessment of which is the responsibility of the Internal audit department.

### ***Credit Risk***

The Group and the Bank are subject to the credit risk. The credit risk is the risk of the customer or co-operation partner being unable to or refusing to meet its liabilities towards the Group or the Bank in full amount and due time.

The Group and the Bank manages the credit risk according to the Credit Risk Management Strategy and Policies as well as internal regulations, procedures and instructions of credit operations.

The Credit Risk Management Strategy and Policies of the Bank describe and define the principles for the management of the credit risk and it relates to all activities of the Group and the Bank involving credit risk – lending, financial market transactions (operations), intermediary activities on behalf of the clients and issue of guarantees to third parties.

Management process of credit risk within the Group and the Bank encompasses establishment of guidelines and limitations, granting of loans or setting limits to particular clients or groups of interrelated clients; administration, monitoring and evaluation of files of clients or interrelated client groups, as well as appropriate control of the process, operation of management information system and evaluation of the total efficiency of the process.

## 2 RISK MANAGEMENT (continued)

In establishment of guidelines and limitations, the Group and the Bank primarily follows the common strategy of the Group and the Bank, credit risk management strategy, as well as their historic experience in credit risk management, which allows defining adequate limitations of concentration, as well as adequate assessment of creditworthiness and collateral, passing decisions in decision-making institutions of the appropriate level. As the common strategy of the Group and the Bank encompasses gradual transformation of the Bank into development bank, the risk stemming from implementation of framework funding programmes becomes an increasingly significant risk source for the Group and the Bank.

The Bank's Lending department and Promotional Programmes Office bear the responsibility for daily credit risk management in lending operations, incl. when setting criteria of creditworthiness and collateral adequacy, while decisions about assuming credit risk within the set limits are made by branch, regional and the Central lending committees, or the Board of the Bank. The daily supervision and administration of loans is conducted on the basis of each individual borrower's risk grade and affiliation, determined by organizational structure of the Group and the Bank.

The Risk management committee conducts the integrated monitoring of credit risk, incl. credit risk concentration and loan portfolio quality, while independent control of credit risk is performed by the Risk management department, its functions are detached from the business functions. Risk management department bears the responsibility for analysis of credit risk concentration, setting of limits and their control, quality assessment of the loan portfolio and building of provisions, as well as independent evaluation of lending operations and daily management of credit risk in operations with financial instruments.

Stress testing of the loan portfolio and scenario analysis is conducted within the Group and the Bank within the framework of the credit risk management on a regular basis, and not less than once a year, which includes changes of various macro-environment affecting factors (for instance, drop of real estate property prices, households' income decrease, contingent changes in development of various industries of national economy, and similar) and demonstrates the eventual impact on the Group's and the Bank's profitability, loan portfolio quality, volume of provisions and level of capital adequacy.

The Group and the Bank manages credit risk concentrations according to the Risk Exposures Controlling Policy that stipulates the methods of analysis of the credit risk concentrations and its controlling instruments including limits on credit risk concentrations. Credit risk concentration is managed by measuring and setting limits on the following concentrations:

- ratio of large exposure concentration and own funds (internal limit - 400%), as of 31.12.2010 was 33.6% (as of 31.12.2009 - 47.1% );
- ratio of single client's (related clients' group) large exposure and own funds, which may not exceed 25%, as of 31.12.2010 was 22.2% (as Bank of 31.12.2009 - 20.7% );
- ratio of risk exposures with persons related to the Bank and own funds, which may not exceed 15%, as of 31.12.2010 was 1.0% (as of 31.12.2009 - 2.6%).
- proportion of risk concentration in a single economic sector in the Bank's credit portfolio and own funds as of 31.12.2010 was 131.9% (as of 31.12.2009 - 120.9% ) in operations related to real estate;

Since the Bank's strategy is not focused on servicing the non-residents business, the proportion of the Bank's total claims to non-residents was small and as of 31.12.2010 was 7.3% (as 31.12.2009 - 7.1%) of the Bank's total assets. The Group and the Bank manages the country risk that results from the lending operations to non-residents according to the Country Risk Management Policy.

The management of the Group and the Bank has performed calculation of losses on the basis of all the facts at its disposal, unbiased proofs of depreciation, and believes the calculations disclosed in the financial reports are reasonable, considering the available information. Nonetheless, having the present awareness, it might occur, as a result of the next year's actual events, differing from the assumptions, that the respective book values of assets and liabilities be corrected.

### **Liquidity Risk**

The liquidity risk relates to the ability of the Group and the Bank to redeem the legally valid claims of its customers and other creditors in due time and secure that the increase of the anticipated claims presents reasonable costs.

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**2 RISK MANAGEMENT** (continued)

The principles for management of liquidity risk are determined by the Liquidity Maintenance Strategy, Liquidity Risk Management Policy and Business Continuity Plan for Liquidity Crisis Situation. The Bank maintains that the liquid assets do not fall below 30% (set by the FCMC) of its short-term liabilities at all times. The Assets and Liabilities Committee of the Bank stipulates the guidelines for liquidity risk management and controls compliance thereof, whereas the Treasury Department provides for daily management of the liquidity risk.

The Bank uses the GAP method to evaluate the liquidity risk. The Bank has set liquidity net position limit in each significant currency and total liquidity net position limit as well as maximum deposit amount from a single depositor to control the liquidity risk. At least once a month, scenario analysis or stress testing is conducted, to reveal the impact of contingencies on liquidity of the Group and the Bank.

Compliance with the liquidity ratio (min – 30%) was 84.76% as of 31.12.2010 (as of 31.12.2009 – 82.2%).

***Foreign Currency Risk***

The foreign currency risk occurs due to the differences between the asset and liability positions of foreign currencies that, as a result of the fluctuations of the exchange rates, affect the cash flow and financial results of the Group and the Bank. The principles for the management of the foreign currency risk are outlined in the Foreign Currency Risk Management Policy of the Bank. Monitoring of the foreign currency risk is conducted by the Assets and Liabilities Management Committee of the Bank, whereas the Treasury Department provides for daily management of the foreign currency risk.

The Group and the Bank maintains a cautious foreign currency risk management policy and controls the foreign currency risk by imposing limits on the open currency positions for each currency and all currencies together consolidating in lats and by complying with the open currency position limits established in the law On Credit Institutions. The biggest exposures for the Group and the Bank were in EUR and USD currencies as of December 31, 2010. Upon evaluation of the foreign currency risk level for the Bank, measuring its sensitivity to foreign currency rate changes, a decision was made that Latvia would continue its participation in Exchange rate mechanism (ERM II), which means that the rate of Lats and Euro would remain fixed. Thus, the impact of changes in foreign currency exchange rates has been measured only for the USD open position. By using a simplified scenario, assuming that the LVL/USD rate would change +/-5% on the final date of the reporting period and assuming that all the other variables remain unchanged, it provides following figures (LVL thousands):

	31.12.2010			31.12.2009		
	USD open position	Impact on profit/loss statement +5%	Impact on profit/loss statement -5%	USD open position	Impact on profit/loss statement +5%	Impact on profit/loss statement - 5%
Group	97	(5)	5	(381)	19	(19)
Bank	(131)	7	(7)	(432)	22	(22)

***Interest Rate Risk***

The interest rate risk is related to the influence of the fluctuations of the market rates onto the interest income and expenses of the Group and the Bank. The management principles of the interest rate risk are defined in the Interest Rate Risk Management Policy. To assess the interest rate risk, the Group and the Bank analyses the maturity structure of the assets and liabilities sensitive to the changes in interest rates and susceptibility of the maturity structure to the potential fluctuations of the interest rates on a regular basis. The Assets and Liabilities Management Committee monitors the interest rate risk, whereas the Treasury Department is responsible for the daily management of the interest rate risk.

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**2 RISK MANAGEMENT** (continued)

With the purpose to minimize the adverse effect of interest rate changes onto interest income and the economic value of the Group and the Bank, the Bank, within the framework of the Interest rate risk management programme, has set established limits, capping the overall interest rate risk exposure to all balance and off-balance-sheet items susceptible to interest rate risks.

Interest rate risk sensitivity analysis is calculated as the impact on net interest income and the economic value of the Bank, with interest rates changing by 100 basis points (thsd. LVL):

		<b>31/12/2010</b>		<b>31/12/2009</b>	
	Change in interest rate	Impact on net interest income	Impact on equity	Impact on net interest income	Impact on equity
LVL	+100/-100 bp	480/(480)	(940)/940	918/(918)	(244)/244
USD	+100/-100 bp	(6)/6	-	4/(4)	-
EUR	+100/-100 bp	(25)/25	(44)/44	(543)/543	(2)/2

Impact on economic value shows impact on equity and have been calculated fixed rate available for sale financial assets for the effects of assumed changes in interest rates based on assumption of parallel shift in yield curve. shows analyses have been calculating using .Sensitivity on interest income is the effect of changes in interest rates on the profit or loss for a year based on the floating rate financial assets and liabilities held at 31 December 2010.

***Operational risk***

The operational risk results from intentional or unintentional deviations from the standards adopted in daily operation of the Group and the Bank, for example human mistake or fraud, disturbances in the operation of the information systems, insufficient control procedures or their ignorance. The Group and the Bank manages operational risk according to the Operational Risk Management Policy. The operational risk is measured by using the method of self assessment and statistical analysis, whereas the operational risk information system, established within the Group and the Bank, is used to identify, analyze and control the Operational risk, it registers and analyses occurrences of operational risk and calculates the scale of actual or potential losses. Structural units of the Group and the Bank are responsible for the management of the operational risk in the daily operations, but the Risk Management Committee supervises the operational risk. The Risk Management Department is responsible for implementation of the operational risk management as well as the operational risk assessment in the Group and the Bank.

The Bank has implemented Business Continuity Plan under the operational risk management measures, which includes guidelines on actions to be taken by the Bank, its structural units and employees at occurrence of risks that can have substantial negative effect on the Bank's operations.

***Capital Adequacy***

Capital adequacy shows the capital resources of the Group and the Bank that are required to protect them against risks, potential and characteristic to the current and future operations of the Group and the Bank.

Capital adequacy maintenance strategy and Capital adequacy evaluation process policy describes the processes of evaluation, planning and maintenance of the capital adequacy.

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## 2 RISK MANAGEMENT (continued)

The goals of the Bank in capital management are:

- comply with the requirements of the Financial and Capital Market Commission, as well as the strategic goals to capital volume requirement and capital adequacy, established by the management of the Bank;
- maintain operation capability of the Group and the Bank, bringing profit to the shareholder and benefiting other interested parties;
- use the capital effectively and support the development of operations of the Group and the Bank by means of a healthy capital base.

Capital adequacy is evaluated on a regular basis and a report is monthly submitted to the supervisory institution, in accordance with the requirements of the Financial and Capital Market Commission.

The Group and the Bank completely follows the requirements of Basel II in their capital adequacy evaluation process. Own funds of the Group are constituted by aggregate of Tier I and Tier II capital, less the reduction of own funds.

In order to calculate the minimum capital charge for credit and market risks according the requirements of the Financial and Capital Market Commission, the Group and the Bank use the standardised approach, and basic indicator approach – for operational risk. As of 31.12.2010, the capital adequacy ratio of the Bank was 16.7% (as of 31.12.2009 - 12.8%) which exceeded the statutory minimum of 8% for the ratio of the own capital and total of risk-weighted assets and off-balance sheet items. In order to maintain that the capital at disposal of the Group and the Bank is sufficient to cover all risks of the current and scheduled operations, the Group and the Bank conducts the internal capital adequacy evaluation process (ICAAP) once a year, calculating capital requirements for those significant risks which do not have minimum regulatory capital requirements determined. The results of the internal capital adequacy evaluation as of 31.12.2010 were as follows:

	<b>31/12/10</b>	
	<b>Group</b>	<b>Bank</b>
Capital base for internal capital adequacy evaluation	104,233	102,542
Total internal capital requirement	68,602	70,047
Internal capital adequacy ratio	12.2%	11.7%
Surplus of capital base	35,631	32,495

Capital adequacy evaluation process includes:

- analysis of changes in operation of the Group and the Bank, according the goals for the next period established in development and risk strategies of the Group;
- identification of essential risks;
- analysis of the amount of own funds at disposal of the Group and the Bank, capital requirements and capital reserves volume;
- planning of capital adequacy and identifying quantitative goals;
- analysis of the results of the capital adequacy evaluation process.

The Group and the Bank have identified the following essential operation-affecting risks for determining the internal capital requirements:

### *Credit risk*

The volume of funds required to cover the credit risk is identified by means of the standardized approach, complemented by a scenario analysis and assessing, whether the volume of funds estimated by the standardized method is sufficient for covering the credit risk of the Group.

## **2 RISK MANAGEMENT** (continued)

### *Market risks*

The volume of funds required to cover the market risk is identified by means of the standardized approach. Complementary to that, the Group performs capital adequacy evaluation by using the internal valuation model, which looks at the actual risk level of the currency risk position. The volume of the internal capital requirement for the risk is determined according the largest value.

### *Operational risk*

The volume of funds required to cover the operational risk is defined as 15% of the median of net interest and noninterest income of the Group for the last three years in aggregate, which is then compared to the accumulated statistical data by the Group accounting for losses incurred by operational risk occurrences within previous periods and the maximum permissible annual losses to operational processes of the Group determined in the annual operational risk evaluation. The volume of the internal capital requirement for the risk is determined according the largest value.

### *Interest rate risk*

The volume of funds required to cover the interest rate risk is defined as the volume of anticipated losses, which may arise due to the economic value of the Group shrinking as a result of interest rate changes, in the case of parallel shift of the interest rate curve by 200 basis points. The volume of estimated losses is defined as the absolute value of the change of the economic value.

### *Risk of laundering of funds derived from criminal activities and terrorism financing (LFDCATF)*

To determine the volume of funds required to cover the LFDCATF risk, the Group analyzes: the ratio of non-resident deposits of the total deposit volume; customers that require further investigation, volume of deposits; changes in the non-resident deposit volume; amount of trust operations. In addition to that, the Group analyzes the efficiency of the internal control system in the area of LFDCATF.

### *Concentration risks*

When determining the volume of funds required to cover the concentration risk, the Group analyzes the concentration risk of a single customer / group of interrelated customers, industry concentration risk, currency mismatch concentration risk and collateral concentration risk in loan portfolio; and include the aggregate volume of funds required to cover these risks in the capital adequacy estimate.

### *Other risks (reputation, strategy, business etc.)*

To cover the other risks, the Group reserves funds according to the simplified method, maintaining respective risk management and risk mitigating activity.

In order to maintain that the funds of the Group and the Bank are sufficient for covering losses in case of contingencies, and are sufficient throughout the entire economic cycle, the Group and the Bank, in addition to funds reserved for risk covering, determine reserve funds by using the simplified method.

The Group and the Bank maintain the cover for the aggregate of the internal capital requirement and capital reserves by own funds, regular evaluation of the internal capital adequacy and maintenance of an adequate level of funds.

Within the framework of capital adequacy evaluation process, stress testing is conducted to provide the confidence that the Group and the Bank are well capitalized with various economic development scenarios.

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### 3 THE PERFORMANCE RATIOS OF THE BANK

Items	Accounting period	Previous accounting year
Return on equity (ROE) (%)	-68.30%	-65.02%
Return on assets (ROA) (%)	-7.65%	-5.60%

### 4 CONSOLIDATION GROUP

No	Name of commercial company	Code of place of registration, address of registration	Type of activity of commercial company *	Share of fixed capital (%)	Voting rights in commercial company (%)	Justification for including in the Group**
1.	SIA „Hipotēku bankas nekustamā īpašuma aģentūra”	LV –Latvija 40003426895	CKS	100	100	MS
2.	SIA „Hipolīzings”	LV – Latvija 40003616329	CFI	100	100	MS
3.	SIA „Risku investīciju sabiedrība”	LV – Latvija 40003952445	CFI	100	100	MS
4.	IPS „Hipo fondī”	LV – Latvija 40003403040	IPS	51.31	51.31	MS
5.	SIA „Rīgas Centra namu pārvalde”	LV – Latvija 40003266805	CKS	100	100	MS
6.	KS "Mazo un vidējo komersantu atbalsta fonds"	LV – Latvija 40003681329	CFI	47.62	47.62	KS

\* IPS – investment management company, CFI – other financial institution, CKS – other commercial company.

\*\* MS – subsidiary; KS – joint venture.

### 5 RATINGS ASSIGNED TO BANK BY RATING AGENCY MOODY'S INVESTORS SERVICE

Rating type	Ratings	Rating Approval date	Previous rating
For long-term foreign currency bank deposits	<b>Baa3</b>	25.06.2009.	<b>Baa3</b>
For short-term foreign currency deposits	<b>P3</b>	25.06.2009.	<b>P3</b>
The financial strength rating	<b>E+</b>	25.06.2009.	<b>D-</b>
The rating of mortgage bonds issued	<b>Baa2</b>	23.04.2009.	<b>A2</b>

Moody's Investors Service reports of the Bank may be found at: [www.hipo.lv](http://www.hipo.lv)

Additional information on the ratings assigned (incl. Legend of ratings) may be found at: [www.moody.com](http://www.moody.com)

These condensed financial reports are to be viewed along with the Bank's Annual Report for 2010.